THE AGENCY RELATIONSHIP PROBLEMS IN SMALL BUSINESS LENDING

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The agency contract has been identified as a major source of problematic relationship between bankers and the small business owners. The problems which arise from this relationship, such as asymmetry of information, moral hazard and adverse selection, cause difficulties for banks to channel the required funds to the small business sector. To overcome these problems, banks require greater level of compensation and protection, such as charging high interest rates, asking for higher collateral requirements, and or imposing some conditional features in the loan contract. However, it is suggested that these bankers need to focus more on understanding small businesses so that the potential of these businesses can be identified for viable funding.

INTRODUCTION

Small businesses, unlike big corporations, do not have access to the capital market, especially where equity finance is concerned, and therefore rely heavily on bank loans for their financial needs. However, when considering loans to these businesses banks encounter a series of risks, and many of these risks arise from agency problems in their relationships. It is also argued that the agency problems are likely to be most significant when the business is small. These, sometimes, affect the willingness of some banks to enter into contract to supply the needed funds to the small business sector. This paper highlights the agency problems in the relationship between banks and small businesses, the use of several loans features to overcome the problems, and other alternatives to increase the accessibility of bank funding to the small business sector.

AGENCY RELATIONSHIP

The agency theory focuses on the relationship under which one or more persons (principals) engage another person (agent) to perform some services on their behalf (Jensen & Meckling, 1976). This contract involves delegating some decision-making authority to the agent. In the case of a small business, the agent is typically the owner, and the principal is the supplier of external fund, notably the bank. This separation of ownership and control may result in a problematic relationship because there is always a possibility that the agent may not act in the best interest of the principal but instead acts in his own self-interest (Peterson, 1994). The small business has considerable operational flexibility that makes it easier to transfer assets to other uses in response to a changing business environment, and this can have an adverse effect to the bank (Pettit & Singer, 1985).

The first problem that arises from the agency relationship is the asymmetry of information. This problem, sometimes referred to as 'hidden knowledge or information', occurs when one party to a transaction knows relevant information which has a material effect on the transaction, but which is not known to the other party (Binks et al, 1992; Amit et al, 1998). The small business owners when approaching the banks for loans always have an informational advantage over the bankers that sometimes leads them to overstate the soundness of their business projects in relation to the funding sought (Storey, 1994). This problem can impede the flow of funds to the small business sector, and the banks may choose to ration the amount of loans they grant or extend credit only on relatively unfavourable terms (Stiglitz & Weiss, 1981).

The second problem to an agency relationship is the moral hazard, often described as 'hidden action'. It is a situation where an agent does not act in a manner consistent with the contract with the principal, or in the principal's best interest (Guesnerie et al, 1988). The issue of moral hazard was first discussed in insurance markets where the insured parties could take actions that either increase or decrease the risk of hazard (Rothschild & Stiglitz, 1976). For example, after purchasing a motor insurance, the insured party could either drive safely or dangerously. Arrow (1973) and Pauly (1979) who conducted earlier work on moral hazard found that it could also cause market failure. In a situation of small business lending, the problem of moral hazard arises where the action of the owner who successfully obtained a bank loan is not directly observable by the banker. This borrower might use the funds for other purposes than stipulated in the contract, sometimes out of self-interest, and such actions may impose high costs on the banker. It can also occur where during the contract period, the incentives of the two parties change, and as a result the riskiness of the contract is altered (Heffernan, 1996).

The asymmetry of information can give rise to a third problem, adverse selection, which causes inefficient allocation in the market (Amit et al, 1998). In this situation, the market may be crowded with 'low quality' projects, simply because it is hard for the lenders to distinguish between good quality and bad quality projects. These lenders have to make decisions based on their knowledge of the borrower's skills and competencies (Read, 1998). The adverse selection occurs in small business lending because bankers cannot distinguish between the two types of borrower, the good risk and bad risk. It is also argued that a bad risk borrower has an incentive to pretend to be a good borrower, and thus benefits from more favourable lending conditions (Cowling & Sugden, 1995). To prevent this problem, the bank may raise the collateral required from the good borrower, thus removing the incentive for the bad borrower to default. But, by doing so the bank also imposes unfair cost on the good borrower.

The agency problems can give rise to costs in maintaining the relationship. These costs include the costs of monitoring and bonding. Monitoring costs occur because the activities of agent (borrower) must be monitored to ensure that he conforms to the contract. Bonding costs are incurred by the agent to guarantee that he will not take certain actions that would harm the principal (banker), and/or to ensure that the principal is compensated if the agent does take such actions. Therefore, these agency problems have contributed significantly to the costs and the availability of funding to small businesses. The bankers often require greater level of compensation and protection to cover the risks and overcome the problems of asymmetric information, such as charging higher interest rates on the borrowers.

OVERCOMING THE AGENCY PROBLEMS

Banks face difficulties in overcoming the problem of moral hazard because it is not economical to devote resources to appraisal and monitoring where the loans are relatively small. When making lending decisions on small businesses, these banks also make errors because of adverse selection. Deakins & Hussain (1994) categorise the adverse selection as Type I and Type II errors. Type I error is where a banker turns down a proposition which turns out to be a business success, and Type II error is where a banker accepts a proposition which turns out to be a business failure. The bankers may be concerned only with avoiding Type II errors and not Type I, as the latter will not affect them unless the banks failed to achieve their targets. These partly explain why some small business propositions which have high potential for growth and profitability, are turned away by the banks.

To cover the risks and overcome the problems of agency relationship, banks may require greater level of compensation and protection, such as charging higher interest rates, asking for higher collateral requirements, and/or imposing some conditional features in the loan contract. Some studies, however, have found out that adjusting interest rates does not reduce the problem of adverse selection or moral hazard. On the contrary, it influences the riskiness of the average borrower as well as the demand for funds. Higher interest rates attract riskier borrowers, an adverse selection problem, and induces borrowers receiving loans to alter their behaviour to adopt more risky projects, a moral hazard problem. Hence, banks may address the problems by restricting the amount of lending rather than increasing interest rates.

Collateral requirement is the most common feature used in a loan contract to help resolve the adverse selection and moral hazard problems. It can be used to signal commitment on the part of the owner to the success of his venture. Collateral can either be pledging of assets owned by the firm or pledging of assets owned outside the firm, typically assets belonging to the firm's owners (Berger & Udell, 1998). The former reorders the claims of the firm's creditors by giving one of them priority through a security interest in specific assets. The latter enhances the claim of a single creditor by conveying recourse against additional assets outside the firm without diminishing the claims of the other creditors in the event of bankruptcy.

Collateral reduces the moral hazard problem because the owner is unlikely to switch into a riskier project or to reduce effort unless he is willing to lose the collateral (Boot et al, 1991). The level of collateral the small business borrower is willing to provide improves his incentives, and certainly influences the lending decision. Of the two forms of collateral, pledging of assets belonging to the owners is more acceptable for small business lending (Avery et al, 1998). Since many small businesses cannot be viewed as financial entities separate from their owners, the personal assets of the owners will play a key role in determining the availability of credit, for which they would otherwise not qualify or be able to negotiate better terms. On the other hand, pledging of a firm's assets cannot be viewed as a complementary arrangement that contributes to enhancing a small borrower's creditworthiness.

Loan covenant is another feature that can be imposed in the contract by the banker. This covenant will limit the actions of the business owner, the borrower. It is intended to give the banker more control and prevent the borrower from engaging in activities against the banker's interest. The borrower must first obtain permission from his banker before embarking on any significant strategic changes such as changing his financial condition or strategy. Studies by Rajan & Winton (1995), Berlin & Mester (1992) and Park (1994) showed that by giving banks the right to renegotiate or call loans when covenants are violated, the efficiency of the loan contract is enhanced. It also gives more flexibility and control on the loan contract. Furthermore, control rights from covenants reduce borrower adverse selection and moral hazard (Smith & Warner, 1979). Firms with most credit risk and greatest moral hazard incentives are also found to the bounded with the strictest covenants (Berlin & Mester, 1993).

However, Berger & Udell (1998) argue that little is known on the use of covenants on small business loans, although there is some empirical evidence to suggest their uses in lending to larger firms. Moreover, effective covenants generally cannot be imposed on small firms, which do not have credibly prepared or audited financial statements (Ravid, 1996). Alternatively, banks can shorten the maturity of loan as a means to control the behaviour of small firms. It is believed that the longer the loan contract is, the greater the opportunity for the borrower to alter his risk behaviour. Shortening the loan maturity can also be viewed as a particularly strong type of covenant. With a sequence of short-term loans, a banker can force negotiation frequently, whereas in covenants, renegotiation can only be triggered by those enumerated in the loan agreement.

Another alternative to overcome the asymmetric information problems of small businesses is to employ commitment loans. A commitment loan is a forward contract issued by a bank to provide loan under pre-specified terms over some future interval, unless the borrower's condition has suffered 'material adverse change', or the borrower has violated a covenant in the contract. A commitment loan can be in the form of overdraft, or in the case of US banks, a line of credit, where it allows the small business to borrow up to an agreed amount at any given time over a specified period. Whether and when a loan is taken down are at the borrower's discretion. The bank is usually compensated in the form of fees charged on unused balances plus up-front fees and usage fees in some cases. The contract also gives the bank a degree of flexibility in the design and enables it to circumvent the losses related to its inability to observe the borrower's action choice. In addition, it provides protection for the borrower against credit rationing or credit crunches of the general market conditions (Avery & Berger, 1991; Cressy, 1996; Morgan, 1998). However, it is also argued that a commitment contract can exacerbate the asymmetric information problem. Because the contract is usually signed at an earlier time where less information is available than for spot loan agreement, it allows borrower to risk-shift to take advantage of the bank (Houston & Venkataram, 1994; Berger & Udell, 1998). Furthermore, the bank will face difficulty to take action on the borrower later in the relationship because of the pre-specified contract terms. Therefore, the bank risk is unambiguously increased because, in some states of nature, it is committed to honour the contract terms it might otherwise refuse.

THE MALAYSIAN EXPERIENCE

Is the relationship between banks and small businesses in Malaysia problematic? This issue has also been the focus of debates among various interested parties, especially the authorities, academics, bankers, small business community and the media. It is often argued that small businesses here have not been getting their due share of bank funding, and the banks also have not been able to take care of their credit needs. Studies have confirmed that small businesses in Malaysia had difficulties in gaining access to the financial institutions, and most of them finance their operations using their own capital, from relatives and friends or through non-institutional sources (Chee, 1986; Hameed, 1995). They also reveal that the proportion of loans, if given to small businesses is much smaller than that of larger firm or that the packages are inflexible to meet their needs. It is also argued that, when faced with financial difficulties, the small business owners seldom or never approach the bank because of limited experience with the bank procedures (Hameed, 1995). Sometimes, the experience of other small business owners who failed to obtain assistance from these institutions may discourage others from even trying to apply a loan from the financial institutions. On the other hand, banks have refuted the claims on the unavailability of bank funding to the small business sector. They are suggesting that there is an abundance of capital to invest but the demand for loans or the viable business propositions from this sector is inadequate.

However, a recent study by this writer (Rosli Mahmood, 2000) confirmed that the agency problems exist too in the relationship between banks and the small business community in Malaysia. The finding of this study revealed a conservative attitude among most of the bank managers when deciding on lending to small businesses. Most of them also took a very cautious approach, especially when confronting with new ventures. This finding also seems to be consistent with the literature, and a plausible explanation for the attitude of these bankers is that, the asymmetry of information is also associated with small businesses in Malaysia. Given this attitude, it would be hardly surprising if these banks were reluctant to finance longer-term loans, where it would incur considerable risk and high monitoring costs.

The banks in Malaysia also operate in an imperfect market where the problems of adverse selection and moral hazard occur, and therefore they are always preoccupied with perceived risks when dealing with small business customers. This pre-occupation with risk, perhaps, may have contributed to the reluctance of some bankers to commit funds to small businesses, even in some circumstances where they were accompanied by collateral or guarantee. In addition, most bankers would always consider the small business proposition from the point of view of a potential risk of loan default rather than future viability of the business or project. The finding also reveals the employment of a mainly 'gone concern' approach among the bank managers when analyzing the financial information. This approach focuses on how a loan would be repaid if the business fails rather than the future prospects of the business itself.

CONCLUSION

The agency problems in the relationship between the banks and the small businesses in Malaysia could cause harmful under-financing to the small business sector. The lack of information could also lead a bank to an excessive caution when assessing loan application form the small businesses. This is further exacerbated by a gap between the bankers and the small business owners. This gap is caused mainly by lacked of understanding among some of the bankers who sometimes perceive small business owners as a potential portfolio of non-performing loans, and thus are reluctant to help them. To address these problems, bankers need to focus more on understanding the small business sector, and work out procedures for channeling required funds to it. They can obtain valuable information through monitoring the operations of the small business borrowers. This helps in building up knowledge of the small businesses, and their potential for viable funding.

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